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SUBJECT: Treasury meets with Finance Ministry and Central Bank

1. (U) Key points:

-- In percentage of GDP, next year's deficit is likely to nearly reach the size that Boutros-Ghali inherited in 2004.

-- Next year's budget contracts in nominal and real terms. Revenues projected to fall fast.

-- The Ministry of Finance is trying to keep fiscal sustainability and subsidy reform high on its priority agenda.

-- The Central Bank of Egypt believes Egyptian banks are in a good position to weather the current downturn.

-- A second phase of Egyptian banking reform is expected to be announced soon.

2. (U) In recent meetings with visiting Treasury Middle East Office Director Francisco Parodi, our GOE interlocutors provided insight into the general status of macroeconomic reforms in Egypt, as well as the government's response to the global slowdown. During the visit, we met with officials at the Ministry of Finance (MOF) and the Central Bank of Egypt (CBE), and other leading economists and analysts. The picture that emerges is one of economic and financial reform and improvements, but at an Egyptian pace and with Egyptian style. The economic slowdown will slow such efforts.

Fiscal Reform - Accomplishments and Challenges

3. (SBU) Historically, the Egyptian budget has been characterized by large deficits and high borrowing. The deficit is driven largely by three significant items which typically constitute 85-90% of the budget: subsidies, public-sector wages, and debt service. The lack of discretionary funding for basic services and urgently needed investment in human and physical capital, continues to be a drag on Egypt's productivity. This issue also contributes to some of the discontent and lack of trust between Egyptians and their government.

In 2004 when Youssef Boutros-Ghali became finance minister, the deficit was 9.1% of GDP and the gross public debt-to-GDP ratio was above 100%. The Finance Ministry made improving these numbers a top priority, initially setting a target of reducing the deficit to 3% of GDP by FY2010/2011. The ministry undertook several policy reforms to accomplish this goal: changing the tax laws to capture more wealth earners; increasing revenues through improved tax administration; more efficient spending by reducing subsidies and eliminating the waste in the allocation of subsidies; and improving the debt management process so as to bring down borrowing costs.

4. (SBU) As a result of changes to the tax code, improvements in tax administration efficiency (supported by USAID), and high growth over the last three years, Egypt has seen the deficit fall from 9.1% of GDP in 2004 to an estimated 6.8% in FY2007/08. Likewise, the total gross debt-to-GDP has fallen from over 100% to about 60%. Even if annual growth had stayed in the 7% range, it is unlikely that the GOE would have reached its deficit target of 3% of GDP in the next two years, but the trend line was positive and the evidence of fiscal restraint and fiscal predictability contributed to the sense

of confidence and optimism that led to strong growth and increased FDI. However, Deputy Finance Minister Hany Kadry told Parodi that he shared our concern that some important revenue enhancers had still not been enacted. For example, the Ministry has developed a full-fledged value added tax (VAT) to replace the existing sales tax, but has deferred introducing it over the past several years, citing high inflation, and now citing the economic downturn. Likewise, a slate of amendments to the tax law has been awaiting ministerial approval for some time. These amendments tighten up the language of the law, including new procedures on collecting tax from small and micro enterprises, a benchmark of one of the U.S. MOUs with the GOE. The GOE significantly reformed real estate taxes last year, but Kadry acknowledged that implementation will not commence until 2010.

15. (SBU) Reham el Dessouki, Senior Economist at Beltone Financial, told Parodi that another unfinished fiscal reform item is pension reform, which she envisions could generate fiscal savings of 2-3% of GDP. (Note: USAID is providing technical assistance for this action.) The government intends to introduce a defined contribution plan to replace the existing defined benefit plan. The new law would allow individuals to see the size and estimated payout of their individual pensions, which is not currently possible. Originally high on the Ministry of Finance's reform agenda, the political realities of this complex initiative have slowed progress.

Reducing and Improving the Subsidy Regime

16. (SBU) Regarding subsidies, Kadry noted that reducing and reforming subsidies remains important to the Ministry of Finance, particularly in the energy sector. Kadry felt that for the energy-intensive industries, prices were starting to get closer to world prices, but that for other consumers and other classes of petroleum, the goal of reaching world prices was still distant. One high profile energy reform, is to bring natural gas to more households, replacing the widely-used LPG ("butagas"). Natural gas is not only much cheaper and less polluting, but also less subsidized than the LPG. The energy subsidy bill is expected to drop in 2009/10, due largely to the falling price of petroleum products, rather than to changes in the application of the regime.

17. (SBU) Kadry noted that the food subsidy, which costs about 2% of GDP, "is money well spent." Dr. Ahmed Galal, the Director of the Economic Research Forum, told Parodi that the subsidy regime in Egypt is completely inefficient and poorly designed. He lamented that Egypt is one of the few countries in the world that is so incapable of administering a real social safety net, it must resort to a byzantine bread subsidy scheme.

Improved debt dynamics?

18. (SBU) While the borrowing burden is growing, Mohammad Assad, Director of Debt Management at the Ministry of Finance, insisted that there remained investor appetite for Egyptian debt and that the nominal increase in the size of the debt should not be viewed as troubling. Debt as a percentage of GDP has been falling and external debt levels are reasonable. He noted that the ministry has been extending maturities and introducing more bonds. Simon Kitchen, Sr. Economist at EFG-Hermes did not seem concerned about the size of the borrowing requirement, noting that Egyptian banks remain more than willing to buy these instruments. He observed that the GOE's heavy reliance on domestic financing is an expensive way to finance the deficit (note: the GOE borrows at around 10%), and said the GOE should consider another external debt issue when conditions are right. He noted that other emerging markets (albeit better risks than Egypt) have recently started again retesting the market.

Stimuli and deficit spending become trendy

19. (SBU) With growth in Egypt expected to fall from 7% to 3.5% this year, Egypt has joined the fiscal stimulus bandwagon. Kadry told Parodi that the 15 billion LE (US\$ \$2.7 billion) stimulus approved by the Parliament in March is already working. Kadry noted that the stimulus, which is largely funding infrastructure projects, is stimulating demand, taking advantage of low commodity prices, and

investing in projects which had both social impact and long-term productivity impact. Kadry emphasized that the stimulus was "budget neutral," noting that it will be financed by higher than expected revenues. When asked how the government was reaping unanticipated revenues in a year when growth was slowing, Kadry explained that income and corporate tax receipts had been sufficiently high prior to the slowdown to offset any slowdown in receipts coming in now. To put things into perspective, Kadry noted that nearly all the listed companies on the Egyptian stock exchange showed strong profit growth in 2008. While stimuli and deficit spending are recommended by the IMF and the G20, he said, Egypt would add new spending cautiously so as not to undermine the gains it has made towards greater fiscal responsibility.

¶10. (SBU) Kadry noted that in the new FY2009/10 budget, revenues are expected to fall significantly, and as a result the GOE will be spending less in both nominal and real terms in the coming fiscal year. Revenues are expected to fall from 289 billion LE (\$51 billion) to 224 billion LE (\$39.7 billion) and expenditures are projected to fall from 356 billion LE (\$63 billion LE) to 319 billion LE (\$57 billion). This will lead to a growth of the deficit in percentage terms (8.0 - 8.5% of GDP) for the first time since 2004/2005, nearly returning to the deficit levels that Finance Minister Boutros-Ghali inherited. Deputy Minister Amina Ghanem observed that a recent MIT study argued Egypt could safely allow its deficit to grow to 8.5% or more of GDP for a short while, if needed to avert a sharper downturn.

¶11. (SBU) The Egyptian fiscal year starts July 1, and a draft budget has been presented to the Parliament. A major outstanding issue is the size of the "social allowance" to be provided to the civil servants. This allowance is the mechanism by which the GOE increases public sector compensation. Contrary to past practice, President Mubarak did not specify the size of the social allowance in his May Day address this year, indicating that the issue remains fluid. Last year, during the peak of the inflationary cycle, Mubarak announced a 30% social allowance increase. This year's draft budget includes 86 billion LE (\$15.3 billion or 27% of the budget) for salaries. On May 7, the press reported that the Government had decided on 5% social allowance.

¶12. (SBU) Most analysts and academics we talked to were positive on the stimulus. Reham el Dessouki believes the stimulus should help fuel demand and enhance longer-term productivity. Samir Radwan, an economist who advises the investment authority, was slightly more critical, arguing that the stimulus was too focused on infrastructure spending, arguing that the stimulus should have tried to affect broader parts of the society.

¶13. (SBU) Assessments of the FY09/10 budget were mixed. Alia el-Madhi, an economist and dean of the economics faculty at Cairo University, was incredulous that the budget will actually contract during a recession. She argued that it should stay the same as FY2008/09, and that the deficit hawks were going too far and would seriously hamper Egypt's growth prospects in FY2009/10JTS2. She further noted that since the private sector follows the public sector, there will be less spending throughout the economy, worsening the slowdownJTS3. Reham el Dessouki was more complimentary of the budget, arguing that President Mubarak's silence on an actual number for the GOE wage increase confirmed her belief that Boutros-Ghali still had clout within the cabinet and was not giving up on his strongly held belief in containing the deficit, even under the current circumstances. She noted that by presenting a budget with such low revenue projections, Boutros-Ghali was essentially forcing Parliament to acknowledge that they could not afford a large wage increase this year, and if they did increase it, he could lay the blame for the increased deficit at the feet of the Parliament.

Central Bank remains bullish on Egyptian banks

¶14. (SBU) Central Bank Governor Farouk el Okdah told Parodi he was very pleased with the way in which Egyptian banks were weathering the financial crisis and the global recession. He took great pride in noting that since he took over in 2004 when the banking system in tatters, the CBE has restructured, recapitalized, and in some cases taken over the insolvent banks, so that today the banks are

weathering the storm well.

¶15. (SBU) El Okdah argued that non-performing loans (NPLs) in the system were down to 10% as a result of the work the CBE had done to force banks to either accept write-offs or settle with bad debtors. He also repeated an oft-heard comment that provisioning at all banks is now at an appropriate level. (Note: The USG funded Financial Sector MOU has required the CBE to report to us on NPL status. Cash transfer disbursements are made based on a pro rata basis based on progress in reducing those NPLs from the 41% they were in 2005 to a target of 20.6% by the end of the program. Based on the most recent data from the Central Bank, which goes through 2007, NPLs stand at 27.5%, much higher than the 10% figure mentioned by the Governor.)

¶16. (SBU) The Governor reiterated that the Egyptian system does not allow "toxic assets", and that the conservative nature of the banks (54% loan-to-deposit ratio) has been a savior for the system. Others told us they agreed that the Egyptian banks' lack of lending saved them during this crisis, but also complained that such a phenomenon led to inadequate credit growth for entrepreneurial needs. Alia Al Madhi was particularly critical of the banks' conservative nature, saying that even though the banks now look shrewd for not lending, it does not change her opinion that banks must start lending more for Egypt's high growth to be sustainable.

¶17. (SBU) The Governor noted that the "first phase" of banking reform is now complete (recapitalization, selling the government share in the joint ventures, selling the Bank of Alexandria, modernizing the remaining state-owned banks, and improving the quality of the banking supervision unit), and that the CBE would soon be launching its "second phase" of banking reform. He has been talking about announcing the second phase for some time, and said that as Egypt is past the crisis, so the second phase will be about "perfecting credit intermediation." He highlighted that the CBE was already doing these things, but he wanted to lay it out with a timetable and goals, covering such issues as: achieving best practice in supervision, implementing Basel II, and perfecting corporate governance. When asked about deposit insurance schemes, he said flatly that they would not formalize such a regime, but that the CBE would never allow a bank to fail.

¶18. (SBU) El Okdah confirmed the CBE intervened in currency markets in March but said that it does so only when the CBE feels the currency is too volatile or that speculators are driving the rate. He noted that he wants supply and demand to determine the rate and has no predetermined rate in mind. The Governor noted that reserves have been falling as the current account surplus has transitioned to deficit, but that he felt that reserves remained adequately strong, and do not present a worrisome sign. Some analysts we met with did note that the rate of 6.0 LE/US\$ is a physiological barrier, hinting that the Central Bank would not want to see the pound cross that line. Given that the pound moves very little in nominal terms, it has seen a real appreciation in the past 12 months, particularly noting that many of its export competitors have seen their currencies decline much more in nominal terms.

SCOBey

[JTS1You might want to put a note about the rates they're paying on their T-bills

JTS2are we talking fiscal or calendar?

JTS3we're not really talking about a recession here, are we?